

COMMONWEALTH OF VIRGINIA
STATE CORPORATION COMMISSION

**Ex Parte: In the Matter Concerning the Provision of Default Service to
Retail Customers under the Provisions of the Virginia Electric Utility
Restructuring Act**

CASE NO. PUE-2002-00645

STAFF REPORT

May 1, 2003

Staff Report

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Introduction

Pursuant to Va. Code § 56-585 of the Virginia Electric Utility Restructuring Act¹ (“Restructuring Act” or “Act”), the State Corporation Commission (“Commission”) established an investigation concerning the provision of default service to Virginia retail customers by Order dated December 23, 2002, in Case No. PUE-2002-00645. Section 56-585 of the Act is included as Attachment 1 to this report. In its Order, the Commission directed the Staff to invite representatives of interested parties to participate in a work group to assist the Staff in developing recommendations on the determination of the components of default service and for establishing appropriate programs for making such services available to retail customers. The Commission further directed the Staff to file a report on such matters on or before May 1, 2003.

Statutory Requirements

As the Commission indicates in its Order, § 56-585 of the Act directs the Commission to determine the components of default service and establish one or more programs making such services available to retail customers requiring them, effective upon the commencement of

¹ Section 56-576 et seq. of Title 56 of the Code of Virginia.

customer choice for all retail customers. The Commission further notes that § 56-577 of the Act requires that customer choice be available to all retail customers in the service territories of all Virginia electric utilities by January 1, 2004.² In Case No. PUE-2000-00740, the Commission adopted a schedule that provides for the statewide implementation of retail customer choice by this date. Consequently, the Commission must establish one or more default service programs effective January 1, 2004.

Section 56-585 F of the Act directly assigns both the obligation and the right to each distribution electric cooperative, or one or more of its affiliates, to supply default services in its certificated service territory at capped rates during the capped rate period, and at the cooperative's prudently incurred cost thereafter.³ For purposes of this subsection, default services include the supply of electric energy and all services made competitive pursuant to § 56-581.1 of the Act. Accordingly, the Staff believes that the Commission does not need to take specific action with respect to establishing default service for retail customers in the service territories of distribution electric cooperatives, other than possibly acknowledging and/or effectuating the statutory prescriptions of this subsection. Consequently, the Commission's

² Except under certain conditions, which have not materialized at present, the provisions of the Restructuring Act are not applicable to any electric utility owned or operated by a municipality (§ 56-580 F of the Act) and are suspended for Kentucky Utilities (amendment to § 56-580 of the Act by HB 2637 in the 2003 Session of the Virginia General Assembly). Consistent with these provisions, the retail customers of these utilities currently do not have the opportunity to choose alternative suppliers of electric energy supply and, therefore, do not require a default service provider.

³ The obligation and right of a distribution electric cooperative, or its affiliate, to provide default service in its service territory is conditioned upon the cooperative, or its affiliates, not seeking to provide default service in the service territory of another electric utility. If the cooperative or its affiliates undertake such activity, then the Commission may designate one or more suppliers other than the cooperative to provide default service in the cooperative's service territory pursuant to § 56-585 B of the Act. At the present time, the Staff is not aware of any distribution electric cooperative, or affiliates thereof, that have pursued such activity or that plan to pursue such activity in the future.

deliberations regarding the establishment of one or more default service programs for January 1, 2004, essentially is limited at the current time to the service territories of Virginia's investor-owned electric utilities, excluding Kentucky Utilities.

Pursuant to § 56-585 B 2 of the Act, the Commission may designate an entity or entities other than the incumbent utility to provide default service through a competitive bidding process, upon a finding that the public interest will be served. Alternatively, pursuant to §§ 56-585 B 3 and C 1 of the Act, the Commission may require the incumbent utility to provide default service within its service territory at capped rates during the capped rate period and at competitive market prices thereafter.

Work Group Discussions

In response to the Commission's Order, the Staff invited interested parties to participate in a work group to assist the Staff in making recommendations to the Commission regarding the provision of default service. Attachment 2 to this report provides a list of the organizations with representatives registered for participation in the default service work group. The work group met twice during March 2003.⁴ Discussions focused mainly on the questions posed by the Commission in its December 23, 2002, Order regarding the characteristics and components of default service and the challenge of establishing the provision of default service by entities other than the incumbent utility during the capped rate period.⁵

⁴ Interested parties from the work group also attended a special meeting in April to offer informal input relative to Virginia Electric and Power Company's proposed default service pilot in Case No. PUE-2003-00118.

⁵ Fifteen parties filed formal written responses. Those responses are posted on the Commission's web site at: <http://www.state.va.us/scc/division/pue/default.htm>.

It should be noted that the formal comments filed by parties in this proceeding reflect significant variations in their visions of the optimal long-term model for the provision of default service. However, in the subsequent work group meetings, most participants appeared to agree in large part that, similar to the implementation efforts of most major restructuring elements, the definition and provision of default service will be a complex and evolving process that should be driven by competitive market development. With a shorter-term focus in mind, most participants appear to believe that an initial determination of the components and characteristics of default service should maintain simplicity with the flexibility to modify such structure as market development provides new opportunities. For example, the majority of work group members favor initially viewing default service as a bundled service – i.e., generation or generation and transmission service, inclusive of all associated ancillary services. In other words, default service should consist of the same components as electricity supply service that may be provided by a competitive service provider at competitive prices or by the incumbent utility under capped rates.

Such a determination would be consistent with the current early stage of competitive retail and wholesale market development. Specifically, a simple bundled default service would reduce initial retail customer confusion. Additionally, in the event the Commission conducts a competitive bidding process, it would facilitate the structuring of a reasonably manageable RFP process for service that is similar to products regularly traded in the current wholesale market, maximizing the ability of potential suppliers to participate. As the market develops and new opportunities are presented, the benefits and costs of unbundling or otherwise modifying the

components of default service should be periodically evaluated. Because of the potential cost impact and lead time required, it should be noted that as default service evolves, retail access rules, electronic data exchange protocols, and business systems would need to be evaluated and modified as appropriate.

Similarly, with respect to other aspects or characteristics of default service, work group participants seem to prefer initial simplicity with evolutionary flexibility. Most participants think, at least during the capped rate period, that default service should conform geographically to the incumbent utility's service territory, and be compatible with customer rate classifications. This approach would avoid potential customer confusion as well as avert certain complications associated with a default service competitive bidding and evaluation process that otherwise might arise due to differing price-to-compare information and/or benchmarks for power supply cost relative to the service territories of two or more incumbent utilities.

Additionally, to mitigate initial complexity, the majority of work group participants believe that distinctions should not be made at present regarding types of default service customers (i.e., those who do not affirmatively select a supplier, those who are unable to obtain service from an alternative supplier, or those who have contracted with an alternative supplier who fails to perform). Certainly, such distinctions may eventually become important with respect to avoiding cost subsidies between types of default customers as well as for structuring incentives to encourage competitive shopping. However, at present, virtually all Virginia retail customers simply lack a reasonable competitive option. This issue should be considered only after further refinement of the objectives of default service in Virginia and should evolve in

response to the development of competitive markets. The more critical short-term focus must be on ensuring that a reasonable and workable basic default service model is in place when capped rates expire or terminate. Consistent with the majority of the work group, the Staff believes that initial simplicity is key to accomplishing this goal.

Several work group participants expressed a preference for either a retail default service model or a wholesale model. Despite a significant work group discussion centered on whether § 56-585 of the Act allows the Commission to designate a provider of wholesale default service to the incumbent utility on behalf of retail customers, a consensus resolution of this issue was not achieved. Several participants were adamant that the Act specifically provided only for a retail default service model. Several other parties asserted that there was nothing in the Act to preclude the provision of wholesale default service. This is one of several issues that the work group must further examine as the default service investigation proceeds.

A corollary question of equal importance is whether such a designation, if allowed, would be the statutory equivalent to designating the incumbent utility as the provider of retail default service, which may trigger the operation of certain provisions within this section of the Act. Such an effect could restrict or offset potential benefits that might otherwise be associated with a wholesale model.

Most work group participants believe there may be significant obstacles at present with respect to the provision of default service by entities other than the incumbent utility. Such factors include: current energy market conditions with high natural gas and wholesale electricity prices; the Act's current capped rate and wires charge structure applicable to Virginia's

incumbent utilities that severely restricts “headroom” for supplier pricing; and the uncertainty regarding Regional Transmission Entity (“RTE”) membership of Virginia’s utilities, as well as unsettled issues associated with the Federal Energy Regulatory Commission’s Standard Market Design (“SMD”).

The Staff believes that absent a significant change in the current capped rate/wires charge structure, there is substantial uncertainty as to the feasibility of an entity other than the incumbent utility providing default service until the end of the capped rate period. When the Staff raised this issue, no supplier attending the work group meeting was willing to represent that it could submit a competitive bid to provide default service in 2004, given the foregoing circumstances. Some participants indicated that the possibility of alternative default service providers, while probably not feasible in 2004, should not be precluded from consideration for 2005, since market conditions and other circumstances could change in a favorable manner. Most members of the work group, including the Staff, seem to agree that there is no reason to foreclose any future possibilities at the present time.

The default service work group has barely scratched the surface of issues to be studied with respect to the establishment of a long-term default service model. However, given the relative infancy of national competitive retail and wholesale markets and the associated unresolved issues, it is virtually impossible at present to develop an ultimate default service model that will produce optimal results for Virginia. As previously indicated, this effort, by necessity, will be a long evolutionary process.

Consequently, the Staff plans to request the continued assistance of the work group in investigating the provision of default service in Virginia. In the next phase of its investigation, the Staff plans to examine various default service models that other states have developed or are developing. The Staff expects that the results from a project examining default service models, being coordinated by the Center for the Advancement of Energy Markets, will be available soon and will provide a starting point for this effort. The most immediate focus of Staff, however, will be the default service pilot program proposed by Virginia Electric and Power Company. The proposed pilot includes a competitive bidding process that may provide some insight with respect to potential issues associated with the Commission's establishment of a competitive bidding process for default service pursuant to § 56-585 B 2 of the Act. The Staff proposes to report the status of its continuing investigation, including any appropriate recommendations, in the Commission's annual proceeding, pursuant to § 56-585 E of the Act.

Conclusions and Recommendations

Based on the foregoing considerations, the Staff is not prepared to advise the Commission that the public interest will be served by the establishment of a competitive bidding process at the current time to designate one or more providers of default service. Accordingly, the Staff recommends that the Commission:

- 1) Determine that effective January 1, 2004, and until modified by future order of the Commission, the components of Default Service include all elements of Electricity Supply Service as defined by the Commission's Rules Governing Retail Access to Competitive Energy Services;⁶ and

⁶ 20 VAC 5-312-10 et seq.

- 2) Require Appalachian Power Company, Delmarva Power & Light Company, The Potomac Edison Company, and Virginia Electric and Power Company, effective January 1, 2004, and until modified by future order of the Commission, to provide default service to all retail customers requiring such service within their respective service territories under the rates, terms, and conditions of capped rate Electricity Supply Service.

Attachment 1

§ 56-585. Default service.

A. The Commission shall, after notice and opportunity for hearing, (i) determine the components of default service and (ii) establish one or more programs making such services available to retail customers requiring them commencing with the availability throughout the Commonwealth of customer choice for all retail customers as established pursuant to § [56-577](#). For purposes of this chapter, "default service" means service made available under this section to retail customers who (i) do not affirmatively select a supplier, (ii) are unable to obtain service from an alternative supplier, or (iii) have contracted with an alternative supplier who fails to perform.

B. From time to time, the Commission shall designate one or more providers of default service. In doing so, the Commission:

1. Shall take into account the characteristics and qualifications of prospective providers, including proposed rates, experience, safety, reliability, corporate structure, access to electric energy resources necessary to serve customers requiring such services, and other factors deemed necessary to ensure the reliable provision of such services, to prevent the inefficient use of such services, and to protect the public interest;
2. May periodically, as necessary, conduct competitive bidding processes under procedures established by the Commission and, upon a finding that the public interest will be served, designate one or more willing and suitable providers to provide one or more components of such services, in one or more regions of the Commonwealth, to one or more classes of customers;
3. To the extent that default service is not provided pursuant to a designation under subdivision 2, may require a distributor to provide, in a safe and reliable manner, one or more components of such services, or to form an affiliate to do so, in one or more regions of the Commonwealth, at rates determined pursuant to subsection C and for periods specified by the Commission; however, the Commission may not require a distributor, or affiliate thereof, to provide any such services outside the territory in which such distributor provides service; and
4. Notwithstanding imposition on a distributor by the Commission of the requirement provided in subdivision 3, the Commission may thereafter, upon a finding that the public interest will be served, designate through the competitive bidding process established in subdivision 2 one or more willing and suitable providers to provide one or more components of such services, in one or more regions of the Commonwealth, to one or more classes of customers.

C. If a distributor is required to provide default services pursuant to subdivision B 3, after notice and opportunity for hearing, the Commission shall periodically, for each distributor, determine the rates, terms and conditions for default services, taking into account the characteristics and qualifications set forth in subdivision B 1, as follows:

1. Until the expiration or termination of capped rates, the rates for default service provided by a distributor shall equal the capped rates established pursuant to subdivision A 2 of § [56-582](#). After the expiration or termination of such capped rates, the rates for default services shall be based upon competitive market prices for electric generation services.
2. The Commission shall, after notice and opportunity for hearing, determine the rates, terms and conditions for default service by such distributor on the basis of the provisions of Chapter 10 (§ [56-232](#) et seq.) of this title, except that the generation-related components of such rates shall be (i) based upon a plan approved by the Commission as set forth in subdivision 3 or (ii) in the

absence of an approved plan, based upon prices for generation capacity and energy in competitive regional electricity markets.

3. Prior to a distributor's provision of default service, and upon request of such distributor, the Commission shall review any plan filed by the distributor to procure electric generation services for default service. The Commission shall approve such plan if the Commission determines that the procurement of electric generation capacity and energy under such plan is adequately based upon prices of capacity and energy in competitive regional electricity markets. If the Commission determines that the plan does not adequately meet such criteria, then the Commission shall modify the plan, with the concurrence of the distributor, or reject the plan.

4. a. For purposes of this subsection, in determining whether regional electricity markets are competitive and rates for default service, the Commission shall consider (i) the liquidity and price transparency of such markets, (ii) whether competition is an effective regulator of prices in such markets, (iii) the wholesale or retail nature of such markets, as appropriate, (iv) the reasonable accessibility of such markets to the regional transmission entity to which the distributor belongs, and (v) such other factors it finds relevant. As used in this subsection, the term "competitive regional electricity market" means a market in which competition, and not statutory or regulatory price constraints, effectively regulates the price of electricity.

b. If, in establishing a distributor's default service generation rates, the Commission is unable to identify regional electricity markets where competition is an effective regulator of rates, then the Commission shall establish such distributor's default service generation rates by setting rates that would approximate those likely to be produced in a competitive regional electricity market. Such proxy generation rates shall take into account: (i) the factors set forth in subdivision C 4 a, and (ii) such additional factors as the Commission deems necessary to produce such proxy generation rates.

D. In implementing this section, the Commission shall take into consideration the need of default service customers for rate stability and for protection from unreasonable rate fluctuations.

E. On or before July 1, 2004, and annually thereafter, the Commission shall determine, after notice and opportunity for hearing, whether there is a sufficient degree of competition such that the elimination of default service for particular customers, particular classes of customers or particular geographic areas of the Commonwealth will not be contrary to the public interest. The Commission shall report its findings and recommendations concerning modification or termination of default service to the General Assembly and to the Legislative Transition Task Force, not later than December 1, 2004, and annually thereafter.

F. A distribution electric cooperative, or one or more affiliates thereof, shall have the obligation and right to be the supplier of default services in its certificated service territory. A distribution electric cooperative's rates for such default services shall be the capped rate for the duration of the capped rate period and shall be based upon the distribution electric cooperative's prudently incurred cost thereafter. Subsections B and C shall not apply to a distribution electric cooperative or its rates. Such default services, for the purposes of this subsection, shall include the supply of electric energy and all services made competitive pursuant to § [56-581.1](#). If a distribution electric cooperative, or one or more affiliates thereof, elects or seeks to be a default supplier of another electric utility, then the Commission shall designate the default supplier for that distribution electric cooperative, or any affiliate thereof, pursuant to subsection B.

(1999, c. 411; 2000, c. 991; 2001, c. 748.)

Attachment 2

**DEFAULT SERVICE WORK GROUP
ORGANIZATIONS REPRESENTED**

Allegheny Energy Service Corporation
Allegheny Power
Amerada Hess Corporation
American Electric Power
American Electric Power Service Corporation
AOBA Alliance, Inc.
Atmos Energy (United Cities Gas Co.)
August Wallmeyer Communications, Ltd.
Christian and Barton, LLP
CNG Retail Services Corporation
Columbia Gas
Conectiv Power Delivery
Constellation NewEnergy, Inc.
Dominion Resources Services, Inc.
Dominion Retail
Dominion Virginia Power
Energy Services Management
EnergyWindow, Inc.
FirstEnergy Solutions, Inc.
Hunton & Williams
KEMA-XENERGY
Kentucky Utilities
Kinnane & Associates, Ltd.
LeClair Ryan PC
McGuire Woods LLP
Mirant Americas
Mr. Charles P. Wilson

Mr. Urchie B. Ellis
National Energy Marketers Association
New Era Energy, Inc.
NOVEC Energy Solutions, Inc.
Old Dominion Committee for Fair Utility Rates
Old Mill Power Company
Pepco Energy Services
Reliant Resources, Inc.
Roanoke Gas Company
SchlumbergerSema NA
Select Energy, Inc.
Shell Trading
Strategic Energy, LLC
Town of Christiansburg
Virginia Association of Counties
Virginia Citizens Consumer Council
Virginia Committee for Fair Utility Rates
Virginia Energy Consortium
Virginia Independent Power Producers
Virginia Maryland Delaware Association of Electric Cooperatives
Virginia Municipal League
Virginia Office of Attorney General
Washington Gas Energy Services
Washington Gas Light Company
Williams Mullen Clark & Dobbins
Woods, Rogers & Hazlegrove, PL